Quarterly Point of View
What's Risk?

July 19, 2021

With the S&P500 notching all-time highs at a pace of every four days in 2021, while rising over 90% in the past 15 months - the best stretch since the 1930's[1] - now is perhaps a good time to once again consider a critical fundamental concept.

Investing is the act of allocating capital with the anticipation of generating income or profit at a point in the future. The dilemma we face as investors in dealing with the future is that it is always, and without question, unknowable. This of course creates risk.

In the world of finance, risk is most often defined as volatility, which is a statistical measure of the dispersion of returns for a security, portfolio or market index and is commonly expressed as the standard deviation or variance of those returns. The reason volatility is used to define risk is because it is statistically quantifiable, and therefore utilized in the development of calculations and assumptions in financial modeling.

Volatility poses challenges to investors through timing and behavioral risks. If a highly-volatile portfolio is in the midst of a significant drawdown at the same time an investor has a need to access those assets, the timing presents a scenario where that downward fluctuation becomes a permanent loss when liquidated, to a degree a lower volatility portfolio wouldn't experience. Timing is not the only risk, however, that volatility poses. Large swings in asset prices draw ever-increasing attention from investors, requiring more and more will power and energy to ignore those swings. In short, it often becomes emotionally draining, reducing an investors capacity to make sound decisions as the stress of those fluctuations makes it hard to differentiate the potentially temporary volatility from an actual loss - so the former often leads to the latter.

Though volatility is quantifiable and therefore used as a definition of risk, it is not the best description. An investor with a long enough time frame and enough emotional fortitude can often overcome the challenges that volatility presents. The best definition of risk in investing, therefore, is the permanent impairment of capital.

Permanent impairment can be defined as a situation where a stock declines significantly because of a fundamental deterioration in a company's business model - in worst cases ending in bankruptcy - but most often where shareholder capital is diminished for an extended period, if not forever. In other circumstances, permanent impairment does not have to be brought on only by a fundamental deterioration in business, but instead by a momentous revaluation of excessively over-priced securities.

940 Willamette Street ▲ The Woolworth Building, Suite 350 ▲ Eugene, OR 97401
tel 541.636.4170 ▲ fax 541.636.4815 ▲ www.martincp.com

Though permanent impairment of capital is a better way of defining investing's true risk, it lacks quantifiable measurement. Simply because it cannot be measured, however, does not mean it is not of the utmost import. "Not everything that counts can be counted and not everything that can be counted counts," said Albert Einstein.

'Time value of money' mistakes are commonplace, and recoverable – but interruptions to the long-term power of compounding by the permanent impairment of capital is hugely detrimental. This is because the math of losses is so damaging, as gains required to recover from a loss are exponential. A stock that declines 10% will require an 11% gain to get back to even, certainly achievable, and in most cases, this is simply defined as normal volatility.

Permanent impairment comes from total or significant loss of 'use' of previously invested capital over extended periods of time. The NASDAQ Composite during the Dot-Com Bubble at the turn of the century offers a vivid real-world example. After peaking in March of 2000, the index declined 78% into 2002, not reaching a new high until 2015. Unlike a 10% loss requiring just one year of an 11% gain to recover, an investor in the NASDAQ at its peak two decades ago required a cumulative return of 350%, or a 13% annualized return – for almost 13 years – just to get back to 'breakeven'!

Given the speculative nature of the current market environment every investor needs to be considering risk, and the degree to which they may be exposed to the potential of permanent impairment of their capital.

The risk of paying too high a price for good-quality stocks - while a real one - is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions ...
Benjamin Graham, The Intelligent Investor

Signs of speculation are everywhere due to many converging factors, but years and years of ultra-low interest rates, now coupled with massive fiscal stimulus, is the primary culprit creating a stampede into riskier assets, many of which can easily be defined as "low-quality." We could cite pages of examples to illustrate the speculative buying of junky securities, but we'll highlight just two that succinctly illustrate this phenomenon.

- Goldman Sachs monitors a "Non-Profitable Tech" index that consists of U.S. listed companies in innovative industries, across industry groupings - that all lose money. As we might predict for unprofitable companies, their performance had been dismal, dropping in value over the previous six years ending in March of 2020. But from that point things dramatically changed, and this basket of "non-profits" rose in value a mind blowing 381% into January of this year.[2]
- There has been a rush by companies to sell shares in secondary offerings of late given investor willingness to buy almost anything. Just this past quarter almost 100 unprofitable U.S. companies have raised money through secondary offerings, twice as many as profitable firms. During the past 12 months alone, almost 750 money-losing companies were able to tap the capital markets and sell shares in the secondary market, exceeding profitable companies who sold shares by the largest margin in 40 years.[3]

Investors have no way of completely avoiding risk, because attempting to do so brings on other forms of risk. Assets meant for investment that are parked in a money-market fund paying nothing, for example, are now "earning" a negative real-rate of return of 3-4% annually. It doesn't take too long to see a significant erosion of the purchasing power of those dollars while trying to "avoid" risk.

With risk "avoidance" presenting its own list of long-term risks, we must focus instead on risk control. Just as the best description of risk is permanent impairment of capital, which is unquantifiable, the best descriptions of risk control are probably qualitative.

This year marks my 25th in this business, and the list below contains some of the primary lessons I've learned – many times the hard way – about what matters in trying to control risk.

- Approach decisions with humility, recognizing what you don't, or can't know.
- Invest in what you know to be true, not what you hope to be true. This is the idea of focusing on consistent, periodic cash dividend payments versus betting on the success of a potential future product launch, for example.
- Pursue the ownership of companies with distinct, proven, and durable competitive advantages.
- Be mindful of the debt leverage a company utilizes.
- Seek thoughtful corporate management who are aware of the risks they bear on behalf of shareholders.
- Avoid excessive valuations, while understanding great companies may trade at premiums to average companies.
- Be willing to act contrary to "popular" ideas.

Risk control may restrain results, often for extended periods and particularly during cycles where participants have discarded any usual caution for hyper-aggressive behavior. We are likely in that cycle at present. Ultimately, however, risk control - seeking to avoid permanent impairment of capital - is a worthy exercise that should greatly aid in increasing the probability of long-term success.

Please feel free to call or email with questions you may have regarding our strategies or Martin Capital Partners in general. You can also find information on our website at www.martincp.com.

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Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC

1. Stocks Make History with S&P 500 Scoring Seven Records in a Row. Bloomberg.com, 7/2/2021.
2. Bianco Research, Bloomberg, January 2021.
3. Record Stock Sales from Money-Losing Firms Ring the Alarm Bells. Bloomberg.com, 6/27/2021.

Statistical and analytical data provided by Factset.

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